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BOARD CHAIRMAN ALAN GREENSPAN

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ALAN GREENSPAN, CHAIRMAN, FEDERAL RESERVE BOARD

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JOINT ECONOMIC COMMITTEE HOLDS A HEARING ON THE STATE OF THE U.S.
ECONOMY

MAY 21, 2003

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BENNETT: The committee will come to order.

We're starting right on time this morning because the Senate is scheduled for a 10 o'clock vote. And with apologies to our House members who have joined us, we will try to get the opening statements out of the way prior to the 10 o'clock vote, break so that senators can come vote and then return, and hope we can move in as expeditious manner as possible. We're pleased to have as our guest today Chairman Alan Greenspan of the Federal Reserve. We always appreciate his views on the current economic situation, as well as his broad perspective on the challenges that we face, both as a nation and increasingly as a world, with the worldwide economy.

Now, it's particularly interesting because today will be Chairman Greenspan's first hearing since the most recent meeting of the Federal Open Market Committee. And changes in the Fed's statements, as well as substantial consumer and producer price declines in April, have generated many questions about deflation, and I hope today's hearing will serve as a fair and open forum for exploring some of the potential answers.

In my own view, the deflation questions facing the United States are fundamentally different than they are for some economies currently suffering from this condition, such as Japan. We don't face the same deflation risks, but it's worth raising the issue and talking about it; we shouldn't take any chances that might come from ignoring it.

The questions of deflation come in the context of a nation that is still awaiting signs that our economy has fully emerged from the recent recession. Many economists predicted months ago that once the fog of war was lifted and uncertainty resolved, the economy would quickly rebound. However, economic indicators continue to paint only a murky picture, precluding a confident declaration that the economy has turned the corner and has begun to approach full stride. For example, far too many Americans are still out of work.

Congress should not wait any longer for brighter signs from the economy. We should send to the president's desk a bold growth and jobs package. And that is in the province of the Ways and Means Committee and the Finance Committee, and I assume that they are doing their work even as we speak.

The final passage of a bold jobs and growth package is an important step, but the next few months will require further activity and Congress has much to do.

We will start the discussion today about what tools we should use in addition to tax cuts to grow the economy and prepare for the future. Some might shrug at the idea of giving serious thought to a foggy future, but, in fact, the future is clearer than some would lead us to believe.

BENNETT: And the biggest feature on the horizon, one that we can forecast with almost a perfect accuracy, is the aging and the retirement of the baby boom generation.

In the year 2011, just eight years away, the first of that generation will reach the age of 65. And as these men and women retire, the nation faces the serious challenge of having fewer workers available to support each retiree. And this will put pressure on Social Security and especially on a system of delivering health care that looks much the same as it did when the younger of the baby boomers still wore diapers. Part of the answer would be to having a fundamentally stronger and larger economy in place when they retire.

So we need to think harder about how we tax capital and how our practice in that area can improve. The tax burden on capital in the United States is higher than imposed by many of international competitors and continued high rates of capital taxation would, by discouraging investment in capital formation in the United States, handicap us in our efforts to meet upcoming challenges.

Just last week, 70 senators voted for a sense of the Senate amendment, instructing this committee, as well as the Finance Committee, to consider tax reforms, specifically including a flat tax. The bipartisan support for this amendment is an encouraging development suggesting that many members of Congress recognize the need not to just cut taxes, but to reform the tax system.

We have other weapons besides tax policies in our arsenal if we are to continue to flourish in the decades ahead and we must consider them. Our key strength on which we must draw is our economy's extraordinary flexibility, which has allowed us to weather an unexpected series of shocks over the past few years.

I observe this flexibility in strong financial markets helping to ensure our nation's financial resources are put to their best use. I see this flexibility as well in the vitality and creativity of small and growing businesses.

BENNETT: This is a unique American phenomenon unduplicated in any other industrialized country. The entrepreneurial spirit, while it springs from a French word, is very much an

American creation.

Thanks to the ingenuity of these small-business owners who risk their capital, thanks to the eagerness and the ability of workers to adapt to new challenges, thanks to a pension system that has increasingly made workers mobile and allowed them to move from one entrepreneurial activity to another and quickly respond to the opportunities that they have, instead of tying them to a single job for a lifetime, thanks to all of these factors, workers go where they are needed most.

On previous occasions Chairman Greenspan has emphasized the economy's flexibility as a key to its long-run growth prospects, and we look forward to hearing him on this subject again today. In particular, I would welcome a discussion about the actions we need to take to enhance and build upon the flexibility in order to grow and meet the upcoming challenges.

With that, I will now recognize Mr. Stark, the ranking member, for an opening statement, and then Mr. Saxton, the vice chairman, for an opening statement, and I would ask the other members of the committee if they would forego their opening statements so that we could move directly to Mr. Greenspan.

Mr. Stark?

STARK: Thank you, Chairman Bennett, for holding this hearing, and welcome. You're looking chipper after your bout at Johns Hopkins, and I welcome you to the alumni of that auspicious group.

I expect that this morning we'll cover other topics, maybe a couple, and the first group I expect will talk about the critical issue of how to put people back to work, get the economy moving again when interest rates are so low that many of the tools of monetary policy may not serve us well.

In the next category we have Congress fussing with a Rube Goldberg contraption of tax cuts that still favor the well to do, and don't seem to have much to do with creating jobs or laying the foundation for sustainable growth.

I hope, Mr. Chairman, that you'll be able to reassure us that the Federal Reserve is committed to getting the economy back to full employment as quickly as possible, and tell us about what means that you have or we have to do it.

SAXTON: We've lost over 2.5 million jobs in the private sector since the current administration took office and things don't seem to be getting any better. We haven't seen such persistent job loss since the '30s.

The Federal Reserve has said that the balance of risks is tilted toward continued weakness and I'd be curious to know what the Fed can do to encourage job creation and growth when interest rates, as I've said, are already very, low.

The question is critically important because you may be our last best hope when the fiscal policy coming out of Congress seems to be a shambles and the tax cut packages squeeze large tax cuts into a tighter budget, which probably if you took off the gimmicks of sunset, would still be over the \$700 billion that was in the original package.

You said in the past that you believe the financial markets assumed long ago that the 2001 tax cuts would not be allowed to sunset and I doubt if there's any reason to take seriously the sunsets moving through now would not be extended. So far from being the best policy to get the economy back to full employment as quickly as possible and enhancing long-term growth, the jobs and growth plans that we're hearing provide little job-creating fiscal stimulus when it's really needed.

The question is whether we pass the future debt responsibilities for retirement and health care challenges along to our children and grandchildren just for the sake of some quick tax cuts now.

Treasury Secretary Snow said that our economy is soggy. I suppose one reason is that the president and the Republicans continue to believe in trickle down policies and that's getting everybody, kind of, damp. But it doesn't seem to be offering any real jobs or a growth plan that would get the economy back to full employment.

So we have a preoccupation with tax cuts and very little talk about economic stimulus and I hope you could provide us some guideposts as to what we might look forward to in the year ahead.

STARK: Thank you for being with us.

BENNETT: Mr. Saxton?

SAXTON: Thank you very much, Mr. Chairman.

It's a pleasure to join in welcoming Chairman Greenspan once again before the Joint Economic Committee.

Thank you for your continuing interest in our committee.

The latest economic figures indicate that the economy is still expanding, although at a very slow rate, as we all know. In recent years, the economy has been remarkably resilient despite terrorism, war and pervasive uncertainty. However, one of the weakest areas in the expansion has been business investment, and until business investment rebounds, it is my opinion that the economy is not likely to expand at a vigorous rate. Although it is clear that the persistent weakness in business investment followed the stock market plunge in 2000, it is not possible to know exactly when it will end.

As the New York Fed president has observed, quote, "The effects of the bursting of the stock market have proven to be far more long term and pervasive than expected," end quote. Some of these effects are readily seen in the weaknesses of the economic and employment conditions that has been apparent for quite some time.

In the last appearance before the committee last November, Chairman Greenspan stated that the economy was in a, quote, "soft patch," and suggested that when the unusual degree of uncertainty facing the economy was lifted, which certainly existed at the time, the rate of economic growth could be expected to increase. Although some of the uncertainty may have been reduced, at least some of it still remains. The latest data suggests that the economy is still quite weak.

We all hope that the economy is poised for acceleration in the last half of the year. However, there is little compelling hard evidence that a pick up in the economic growth is on the horizon. There has been recovery in business profits and some other indicators, but there have been many other signals of continued economic fragility.

In the economic environment that exists today, it is reasonable to consider adjustments of economic policy. Congress has responded with tax legislation designed to boost investment and create economic growth.

SAXTON: But given the weaknesses and the downward pressures on prices, the Federal Reserve, in my opinion, should implement another incremental easing of monetary policy. If policy is eased and the pace of economic expansion does not take off in the second half of the year, monetary policy could readily be adjusted to take this into account.

I might note also that low short-term interest rates do not prevent the Fed from easing monetary policy. As Chairman Greenspan indicated in the JEC hearing last fall, if short-term interest rates fall close to zero, the Federal Reserve can still lower long-term interest rates or operate in other markets to expand reserves and thereby further ease its monetary policy.

The decline in the value of the dollar, obviously, is a factor to be considered, but it is clear that this decline is not the result of an inflationary monetary policy. In the absence of inflation, the risks of other easing are low, and such a move is already expected in the financial markets, and I believe has been factored in by many.

The risks posed by the weaknesses in domestic and international economy appear to exceed the risk that inflation will emerge as a serious problem in the foreseeable future.

Mr. Chairman, thank you for permitting me to make that statement, and I look forward to the chairman's testimony.

BENNETT: Thank you very much.

Chairman Greenspan, again, we welcome you and look forward to what you have to share with us this morning.

GREENSPAN: Well, thank you very much, Mr. Chairman. I very much appreciate the opportunity to testify before this committee.

As you will recall, when I appeared here last November, I emphasized the extraordinary resilience manifested by the United States economy in recent years -- the cumulative result of increased flexibility over the past quarter century.

Since the middle of the year 2000, our economy has withstood serious blows: a significant decline in equity prices, a substantial fall in capital spending, the terrorist attacks of September the 11th, confidence-debilitating revelations of corporate malfeasance, and wars in Afghanistan and Iraq.

Any combination of these shocks would arguably have induced a severe economic contraction two or three decades ago. Yet remarkably, over the past three years, activity has expanded, on balance; an outcome offering clear evidence of a flexible, more resilient, economic system.

GREENSPAN: Once again this year, our economy has struggled to surmount new obstacles. As the tensions with Iraq increased early in 2003, uncertainties surrounding a possible war contributed to a softening in economic activity. Oil prices moved close to \$40 a barrel in February, stock prices tested their lows of last fall, and consumer and business confidence ebbed.

Although in January there were some signs of a post-holiday pickup in retail sales other than motor vehicles, spending was little changed, on balance, over the following three months, as a gasoline price surge drained consumer purchasing power and severe winter weather kept many shoppers at home.

Businesses, too, were reluctant to initiate new projects in such a highly uncertain environment. Hiring slumped, capital spending plans were put on hold, and inventories were held to very lean levels. Collectively, households and businesses hesitated to make decisions, pending news about the timing, success and cost of military action: factors that could significantly alter the outcomes of those decisions.

The start of the war and its early successes, especially the safeguarding of the Iraqi oil fields, were greeted positively by financial and commodities markets. Stock prices rallied, risk spreads narrowed, oil prices dropped sharply, and the dour mood that had gripped consumers started to lift: precursors that historically have led to improved economic activity. The quick conclusion of the conflict subsequently added to financial gains.

We do not yet have sufficient information on economic activity following the end of hostilities to make a firm judgment about the current underlying strength of the real economy. Incoming data on labor markets and production have been disappointing. Payrolls fell further in April and industrial production declined as well.

Because of the normal lags in scheduling production and in making employment decisions, these movements likely reflect business decisions that, for the most part, were made prior to the start of the war, and many more weeks of data will be needed to confidently discern the underlying trends in these areas.

GREENSPAN: One reassuring development that has been sustained through this extended

period of economic weakness has been the performance of productivity. To the surprise of most analysts, labor productivity has continued to post solid gains. Businesses are apparently continuing to discover unexploited areas of cost reduction that had accumulated during the boom years of 1995 to 2000, when the projected huge returns from market expansion dulled incentives for a seemingly mundane cost savings.

The ability of business managers to reduce costs, especially labor costs, through investment or restructuring is, of course, one reason that labor markets have been so weak.

Looking ahead, the consensus expectation for a pickup in economic activity is not unreasonable, though the timing and extent of that improvement continue to be uncertain. The stance of monetary policy remains accommodative, and conditions in financial markets appear supportive of an increased pace of activity. Interest rates remain low and funds seem to be readily available to creditworthy borrowers. These factors, along with the ability of households to tap equity accrued in residential properties, should continue to bolster consumer spending and the purchase of new homes.

The recent declines in energy prices are another positive factor in the economic outlook. The price of West Texas intermediate crude oil dropped back to below \$26 per barrel by the end of April, but as indications of a delay in the restoration of Iraqi oil exports became evident and geopolitical risks crept back in, prices have risen to near \$30 a barrel; a worrisome trend if continued.

Nonetheless, the price of crude oil is still about \$10 per barrel below its peak in February. This decline has already shown through to the price of gasoline in May. Some modest further declines in gas prices are likely in coming weeks, as marketers' profit margins continue to back off from their elevated levels of March and April to more normal levels.

GREENSPAN: In contrast, prices for natural gas have increased sharply in response to very tight supplies. Working gas in storage is presently at extremely low levels, and the normal seasonal rebuilding of these inventories seems to be behind the schedule which we typically perceive during the spring through the fall months. The colder-than-average winter played a role in producing today's tight supply situation, as did the inability of heightened gas well drilling to significantly augment net marketed production.

Canada, our major source of gas imports, has little room to expand shipments to the United States. Our limited capacity to import liquefied natural gas effectively restricts our access to the world's abundant supplies of natural gas.

The current tight domestic natural gas market reflects the increases in demand over the past two decades. That demand has been spurred by myriad new uses for natural gas in industry and by the increased use of natural gas as a clean-burning source of electric power.

On balance, recent movements in energy prices seem likely to be a favorable influence on the overall economy. In the short run, lower energy bills should give a boost to the real incomes of households and to business profits.

To be sure, world energy markets, obviously, remain susceptible to politically driven supply disruptions, as has been evident recently from the events in Venezuela and Nigeria. But, even taking account of these risks, futures markets project crude oil prices to fall over the longer run, consistent with the notion that current prices are above the long-term supply price of oil.

As has been the case for some time, the central question about the outlook remains whether business firms will quicken the pace of investment now that some, but by no means all, of the geopolitical uncertainties have been resolved.

A modestly encouraging sign is the backlog of orders for nondefense capital goods excluding aircraft, which has been moving up in recent months. Moreover, recent earnings reports suggest that the profitability of many businesses is on the mend.

That said, firms still appear hesitant to spend and hire, and we need to remain mindful of the possibility that lingering business caution could be an impediment to improved economic performance.

GREENSPAN: One new uncertainty in the global economic outlook has been the outbreak of severe acute respiratory syndrome in Southeast Asia and elsewhere. This epidemic has hit the economies of Hong Kong and China particularly hard, as tourism and business travel have been severely curtailed and as measures to contain the spread of the virus have held down retail sales.

To date, the effects of SARS on the U.S. economy has been minimal. Airlines have obviously suffered another serious blow, and some U.S. multinational corporations are reporting reduced foreign sales.

But the effects on other industries have been small. Initially, there had been some concern that SARS would disrupt the just-in-time inventory systems of U.S. manufacturers. Many of those systems rely on components from Asia, and any disruption in the flow of these goods has the potential to affect production in the United States. So far, however, U.S. manufacturing output has not been noticeably affected.

In recent months, inflation has dropped to very low levels. As I noted earlier, energy prices already are reacting to the decline in crude oil prices, and core consumer price inflation has been minimal. Inflation is now sufficiently low that it no longer appears to be much of a factor in the economic calculations of households and businesses. Indeed, we have reached a point at which, in the judgment of the Federal Open Market Committee, the probability of an unwelcome substantial fall in inflation over the next few quarters, though minor, exceeds that of a pickup in inflation.

Mr. Chairman, the economic information received in recent weeks has not, in my judgment, materially altered the outlook. Nonetheless, the economy continues to be buffeted by strong cross currents. Recent readings on production and employment have been on the weak side, but the economic fundamentals -- including the improved conditions in financial markets and the continued growth in productivity -- augur well for the future.

Thank you. And I look forward to your questions.

BENNETT: Thank you very much.

Mr. Saxton has to leave. He has an assignment on the House floor. So with the permission of my colleagues, I will go out of order and recognize Mr. Saxton to ask the first question and take the first round.

SAXTON: Thank you very much.

Let me just ask two questions.

SAXTON: Last November, when you were here, Mr. Chairman, we discussed the downward pressure on prices and options available to the Federal Reserve to combat it. Yet some still seem to believe that low short-term interest rates limit the potency of monetary policy. As I pointed out in my statement, last time you were here, you shed some light on that subject.

Could you explain how the Fed could address unwelcome downward pressures on prices through the purchase of long-term Treasury securities?

GREENSPAN: As I and a number of my colleagues have stated recently, we have chosen to act solely in overnight funds, essentially addressing the reserve balances of the banks. There are a number of reasons why we did that, but the point at issue is that there is no legal requirement that we do so, nor indeed an economic one.

And should it turn out that, for reasons which we don't expect, but we certainly are concerned may happen, the pressures on the short-term markets drive the federal funds rate down close to zero, that does not mean that the Federal Reserve is out of business on the issue of further easing and expansion of the monetary base.

We indeed, as you point out, can merely move out on the yield curve, because as you're well aware, even though short-term rates are something slightly over 1 percent, longer-term rates are up significantly above that. And we do have the capability, should that be necessary, of clearly moving out on the yield curve, essentially moving longer-term rates down and in the process expanding the monetary base and the degree of monetary stimulus.

And since there is such a significant amount of potential in that longer-maturity structure, we see no credible possibility that we will at any point, irrespective of what is required of us, run out of monetary ammunition to address problems of deflation or anything similar to that which disrupts our economy.

SAXTON: Thank you.

Mr. Chairman, in your remarks, you talked a good deal about energy prices. In regard to oil prices in particular, I note from our studies that oil prices have not been moving in a straight line.

Beginning in about March we saw oil prices begin to come down significantly and then they ticked back up. And then following that tick in March or April, they continued on down and then ticked back up. And then after that second tick back up, they continued to come down and now they've ticked back up.

And so, I would interpret this as the general direction of oil prices and energy prices becoming lower. Is that a good interpretation?

GREENSPAN: That's certainly what the commodity markets are suggesting; namely, the futures markets.

The initial sharp reaction on the downside occurred when it became evident not that the war would necessarily not be associated with significant problems in the oil fields, but that whatever happened the uncertainty of the mere time frame as to when the war would begin was removed, and there was a general expectation of once the war started, it would end quickly. And as a consequence of that, markets of crude oil fell very sharply.

Then when the oil fields became clearly under control and the expectation of the resumption of Iraqi crude exports became evident, prices worked their way lower for fear that there would be some form of glut.

When it became evident, as I mentioned in my prepared remarks, that Iraqi exports were not coming back very quickly -- they were coming back obviously, but not at the pace that the markets had assumed -- markets have backed up, and the last I looked there were somewhat below \$30 a barrel for West Texas intermediate crudes.

SAXTON: Thank you very much, Mr. Chairman.

And Mr. Chairman, thank you for permitting me to go out of order.

BENNETT: We appreciate your attendance and your participation.

BENNETT: Mr. Stark?

STARK: Thank you, Mr. Chairman.

And thank you, Chairman Greenspan.

In the conclusion of your remarks, it sounds to me that you're suggesting that the main problem facing the economy is weak demand, therefore sluggish growth and high unemployment. You say, "Recent readings on production employment have been on the weak side." And you also seem to suggest that our long-term growth prospects are OK. You say, "Continued productivity augers well for the future."

That seems to leave us with shorter-term stimulus for demand as what's left for us to do in the policy field to see whatever we can do to get full employment as quickly as we can without

increasing long- term debt by too much.

Is that the dilemma that faces us as policy makers: What can we do to stimulate a short term demand without borrowing excessive amounts of money? And that's my question. It seems to me that's what's left for us to do.

GREENSPAN: Congressman, I think that the first decision that any policy maker in this environment has got to make a judgment about is, one, whether the economy is turning, and whether it's potential pace on turn and thereafter is enough to obviate the need for further stimulus. Clearly, we at the Federal Reserve perceive monetary policy as the primary tool in this government for short-term monetary and for short-term stimulus.

It's been the general conclusion of economists over the years that the difficulty in timing fiscal policies, merely because of our congressional structure and the particular procedures which you are far more aware of than I, makes it difficult to calibrate fiscal policy in a timely manner. And therefore, most economists have generally eschewed in recent years the use of fiscal policy as short- term stimulus.

Now it turned out that with the 2001 tax cut, that indeed the actual implementation of the tax cut did come at a time when it seemed to be propitious for short-term stimulus. And that has apparently revived some views about the use of fiscal policy as short-term stimulus. And there are arguments, I must say, in favor of it. I still think that monetary policy should take the lead in the short run, largely because we can move on 20 minutes' notice in 10 minutes, if necessary, where that is obviously not feasible in the fiscal ring.

Having made the judgments, then the question is, to do what. And there is the obvious problem of short-term fiscal stimulus which we could arrange. In other words, you can get a very significant short- term surge, perhaps in retail sales, with a very marked short-term decline in taxes, for example.

The problem is that if you succeed, the difficulty is that it is short term and it tends to fade, and if it creates levels of production which reduce unemployment as a consequence, over time it reverses, and it's not a longer-term phenomenon.

And therefore, you have to make the judgments as to whether fiscal stimulus should be directed at consumption or investment. My own view is I would much prefer the latter because I have always perceived fiscal stimulus as an intermediate- to longer-term policy tool.

But these are judgments that very thoughtful economists disagree on. I mean, there is not a uniform view which you'll get a collective wisdom on in these areas.

STARK: Well, as a thoughtful economist, let me ask you, faced with perhaps the capacity at 60 or 70 percent, wherever it is, we have excess capacity in manufacturing...

GREENSPAN: In manufacturing.

STARK: ... and faced with high unemployment and an expiration of unemployment benefits, for example, what are the pros and cons of saying, "Wouldn't extending unemployment benefits to a couple of million people send them right out to Wal-Mart to buy the shoes and food that they need and give us at least a short-term boost there with some social benefits?"

GREENSPAN: Mr. Stark, I've always been of the opinion, and stated before this committee previously, that our unemployment insurance system seems to work rather well. It is not overly generous, which would induce the type of increased levels of structural unemployment, which we see in other countries which have these types of things -- these types of structures.

But unemployment insurance is essentially restrictive because it's been our perception that we don't want to create incentives for people not to take jobs.

But when you're in a period of job weakness, where it is not a choice on the part of people whether they're employed or unemployed, then obviously you want to be temporarily generous. And I think that's what we have done in the past, and I think it's worked well.

With respect to the immediate future, I don't have a judgment on any particular program, but I would suggest that if you go forward with additional extensions, I would be careful to keep the extensions relatively short and renew them again if necessary. Because we're not quite clear at this stage what the path of short-term economic activity is. A number of major economic forecasters have forecasts for the third quarter, which is just about in front of us, of 4 percent growth at an annual rate. And that is a relatively long list.

Now, anybody with a little arithmetic will tell you that that means that this economy has to start to move very quick to get there.

STARK: I don't know how happy you've made Chairman Bennett and myself, but by saying two 13-week periods, instead of one 26, you think, "We get to announce twice and get twice the accolades for doing it." What a great idea. Thank you, Mr. Chairman.

BENNETT: We get to argue about it twice.

There are roughly five minutes left on the vote on the Senate floor. For those that are watching the clock in the back, it is 13 minutes slow, so we won't do that. I will turn the gavel over to Mr. Ryan, who is the most senior Republican here, and encourage the House members to remain and continue the questionings while the senators go over and save the republic, or whatever it is we do while we vote.

And Mr. Ryan, Mr. Putnam was the first member of the House to show up, if you want to honor the early bird rule. And if you want to wait to get out and use your vast power to question yourself...

RYAN: I guess that means I'd have to ask questions last, if I wanted to honor the early bird, doesn't it?

Mr. Putnam?

BENNETT: Do the right thing.

PUTNAM: I thank the distinguished elder chairman...

RYAN: You're welcome.

PUTNAM: ... angering the 20- and 30-somethings of the House caucus.

Mr. Chairman, I want to address briefly the issue of the housing sector. The consumer confidence has been all over the map, but appears to be on the rise right now. A great deal of our reliance on the fundamentals of the economy, thus far, as we have gone through this soft patch, have been as a result of continued consumer spending and the money that they have been able to extract from the value of their home and continued strong real estate prices.

What is your outlook for the continued explosion of refinancing and the extraction of equity from the housing market and the continued strong home sales for the remainder of this year?

GREENSPAN: First, let me stipulate that while cash-outs, extraction of moneys in the process of refinancing, have become a very big number in recent quarters, they still fall short of the equity extraction that occurs as a consequence of the sales of existing homes, when obviously the seller of a home cancels a mortgage which is much smaller than the mortgage taken out by the buyer, and the difference between those two numbers is, by definition, the net increase in debt on that home and the extraction of equity, essentially, by the seller.

Having said that, it's important to recognize that a goodly part of the extraction of equity has been an ongoing issue related to a very high level of existing home sales, which has not deviated very much, as you well know, in recent quarters. What has changed is a very extraordinary shift in the way the mortgage market functions.

GREENSPAN: We had a huge surge in refinancings late last year, as the mortgage rate on let's say the fixed 30-year mortgage rate fell significantly below the average coupon on existing mortgages, meaning that the gap was widening, and therefore the presumption would be, as indeed it was, that a very large number of refinanciers would come into the market.

And we had a huge number of refinancings and very large cash- outs.

That number dipped a bit in the first quarter, but in recent weeks it's come back up again. Refinancings in the second quarter looked to be very large.

The cash-outs, however, are not as large relative to refinancings as they've been. That is, there's some evidence that there's -- while the refinancings have gone up dramatically in order to reduce the average coupon, we have not seen a major increase in cash-outs as a result.

Let me also point out that surveys by the Federal Reserve indicate that equity extraction from

homes, especially under -- and refinancings -- tend to be very significantly employed to repay other debt. And first of all, they're a major source of repayment on home equity loans, but they have also shown up as a major factor in reducing the burden of consumer debt.

So all in all, it's turning that the technology, which is obviously at the base here of where this refinancing's coming from, has changed the housing market in a rather fundamental -- I should say, the financing of the housing market -- and it has made it a vehicle for liquefying household wealth. And it's been a major factor in consumer activity. And I might say to you that my suspicion is that it's going to increase rather than decrease as a factor in the American consumer markets as home ownership continues to increase.

PUTMAN: That technology that you referred to has fueled a historic growth in productivity across all sectors of the economy. And you have been an eternal optimist about the continued ability of our economy to produce productivity gains. Does that situation then yield another jobless recovery, where these continued productivity gains will not put more people back to work as we emerge from this soft patch?

GREENSPAN: No, Congressman. It does, however, raise the hurdle of what the rate of increase in GDP must be in order to get employment rising, because clearly the arithmetic is straightforward.

Productivity is essentially the rate of growth in GDP minus the rate of growth in hours. And in the most recent period what we've seen is a modest, sluggish increase in real GDP and a decline in hours. And one could argue that if productivity were weak, American businesses would have to employ more people to meet the demands of the marketplace, weak as it is.

As it's turning out, what we are finding is that American business is increasingly being able to meet what has been a tepid rise in sales with an ever-lower work force, which means either the use of technology or restructuring in manners which employ improved productivity.

We should never look at productivity growth as anything negative, because that's where standards of living come from, that's where real wealth comes from, that's what indeed has made this economy the most extraordinarily productive in the world. But it does raise the hurdle of what the growth rate overall must be if we're going to keep our labor force employed.

PUTMAN: I thank the chairman very much.

RYAN: Mr. Hill?

HILL: Mr. Chairman, thank you for being here this morning.

In listening to your testimony, you made the statement that monetary policy should lead in terms of stimulating the economy, that a short-term stimulus package -- I'm assuming you mean through tax cuts -- tends to fade.

GREENSPAN: Unless it is an incentivizing investment. Then it's a different deal.

HILL: The tax cuts that were proposed in the House, as a member of the House I voted against because I believe that deficits matters, and I think that the tax cuts are only contributing to the deficit problem that we have.

On February the 13th of this year you said, and I quote, "Contrary to what some have said, when deficits go up it does affect long-term interest rates, it does have a negative impact on the economy."

We're about to make some decisions in Congress, maybe this week, about whether or not we should have a tax cut. Now, in my view, we shouldn't, because it contributes to the debt. What's your view? What should we do?

GREENSPAN: I think what is required in doing any, sort of, analysis is to, on the one hand, try to evaluate the gross positive impact from any fiscal program; one, for example, that is budget neutral on the one hand and one which may be contributing to budget deficits.

If it's the latter, then the issue I was raising with respect to interest rates is that in order to get the net impact, plus or minus, it's important to reflect the fact that indeed changes in the longer- term fiscal outlook are very clearly a factor in the level of long- term interest rates today.

And as a consequence, if you engage in a program which significantly alters the long-term deficit outlook to a point that long-term rates are raised, it may or may not be curtailing economic output -- let's put it this way. It requires an analysis of what the extent of the curtailment in economic output would be as a consequence of higher long-term interest rates to net it against the gross incentive flows and productive flows that occur from some form of tax cut -- long-term tax cut program.

The point I was making is, deficits do matter, and that in any evaluation of a program what happens to deficits is an integral part of the analysis.

HILL: I want to make sure that I heard you right. Did you say that any kind of tax cut should be revenue neutral?

GREENSPAN: Not necessarily revenue -- budget neutral. In other words, I must admit that in the debate that's been going on on the issue of fiscal policy it really is a debate between whether or not deficits are increased by spending or by tax cuts. I'm waiting to hear the third stool -- I was going to say the third foot. I was wondering what kind of an animal.

(LAUGHTER)

But what is missing here and was never missing in previous discussions is restraint on spending.

I am increasing of the view that the huge surpluses which we created in our budget, which were wonderful things to observe, have severely undercut fiscal restraint: the type of restraint that existed before the surpluses emerged.

And as our chairman indicated, we are looking at the potentials of the significant demographic problem as we get beyond 2011, and it's something which requires a really very close look at the size of the commitments for spending that we're making.

GREENSPAN: And I think that I would very much like to see that issue addressed far more than it is. I must say, the silence is deafening.

HILL: I couldn't agree with you more, Mr. Chairman.

I've got the red light on me just now, so maybe I'll ask another question later, but thank you for your answer.

RYAN: Although it's very tempting to want to follow up on what Mr. Hill just said, I shall recognize Mr. Paul.

PAUL: Thank you, Mr. Chairman.

Good morning, Mr. Greenspan.

I have two questions. One is generalized and it deals with the dollar system and the monetary system that you're required to operate, and then one more specific, a factor that affects the strength of the dollar.

But the big debate now in financial circles is the weak dollar, whether it's good or bad, versus what a strong dollar should do to us, or for us. And I would like to suggest that there should be another alternative rather than arguing a temporary case for a strong dollar to help us, which it seemed to in the latter part of the 1990s, versus whether the weak dollar will now help us on our exports.

Rather than this manipulation of the value of the dollar, I would hope someday that we will talk about a stable dollar, one that does not fluctuate so readily. We deal in the world today with fluctuating exchange rates and all currencies are inflated at different rates, and nobody advocates that we have 50 different currencies in this country; that would be totally chaotic. And yet the world is required to operate, and there is no soundness to it, no restraint on the monetary authorities.

And the other challenge, I think, that we have to look at some day is whether we should continue to accept this notion that we can achieve positive central economic planning through the monopoly control of money and credit and setting of interest rates, which is really contradictory to true capitalism. And I think that's where part of our problem is. The Austrian economists for years, Mises and Hayek and Rothbard, have argued that this is the source of our problem, that the manipulation of interest rates too low causes the boom, and then eventually the bust has to come.

And we see this over and over again, but we talk about productivity and other events that are important, but we fail to talk about the initial cause of the mal-investment, the overcapacity,

which then requires the correction.

Because we operate the reserve currency to the world, we have the advantage of others taking our money and our dollars and holding them. But currently the expectations are that our current account deficit may soar to \$600 billion next year. And we do know throughout history, and most economists agree, that these current account deficits cannot be maintained or it'll eventually lead to a weaker dollar and higher interest rates.

So I think you're under the gun. In one sense, you want to stimulate the economy with low interest rates, which weakens the dollar, at the same time the weak dollar will eventually push up the interest rates.

And my question there is when do you think, or do you think we will ever, talk once again about sound, stable currency?

And the other question is more specific, because even though what the Fed does in the creation of new money is the key element, other things do have factors. The jawboning and the so-called speculators, for a day or two they have an effect, but they really can't change it. Jawboning doesn't work. Ultimately, in 1979, interest rates had to go to 21 percent to restore some order to the dollar.

But you talked about the war and the supposed benefits after the war was over and after it started, but I think what has not been recognized is the ongoing foreign policy of our adventurism and our plans, really -- those same people who planned and argued the case for Iraq are arguing the case for Syria and they're arguing the case for Iran. At the same time we don't have our allies close to us, we don't have people pouring in the dollars like we did in the 1990s. So that in itself has a subjective relationship to the perceived value of the dollar.

And I wanted to know whether or not you think that element in foreign policy today specifically has affected the future perceptions of what the dollar's value is going to be.

GREENSPAN: Well, Dr. Paul, I -- first, let me address the last question first. As I think you may remember that we in the United States government have made a decision in which the value of the American currency will be discussed only by our chief economic spokesman, which is the secretary of the Treasury. And we at the Fed have adhered to that for quite a good, long period of time and think it's important to have one voice speaking on that issue.

GREENSPAN: With respect to the more general question about the issue of sound, stable currencies, this, as you know, is a very fundamental debate amongst economists.

You point out quite correctly that there is a single currency in the 50 states of the United States. The reason why we were able to function in a manner which others are not is that an exchange rate that is a unit-specific currency tends to bring together all of the imbalances in an economy in the exchange rate's price. In other words, at the border the exchange rate essentially rebalances all of the imbalances between two contiguous countries or it might have been in the United States between two states.

If you lock the currency in and you cannot adjust the currency at the border, then the adjustments must occur in capital flows or in labor flows; the only two other ways in which you can get major adjustments that are required between two disequilibrium economies.

The advantage of the United States is that, because we have stripped out all barriers to interstate commerce essentially -- I should say most -- we are able to get equilibria adjusted solely through capital and labor market flows and we have a fixed currency.

The reason why it is not, at this moment, feasible in a lot of other areas of the world is that capital and labor flows are not adequate to pick up the full adjustment process. And an endeavor to fix exchange rates in the face of imbalances induces financial breakdowns has occurred.

PAUL: May I just interject? I'm not talking about fixing these rates. I'm talking about a single currency that could be universalized.

GREENSPAN: That's the algebraic equivalent of fixing rates. In other words, if you lock in legally all rates, it's irrelevant what you call the currency in one nation and another; it's the lock that matters. And if you have, for example, as we did, the gold standard, which for a very substantial period of time was the single currency of the world, it didn't matter what you called the other currencies, because they were all locked-in in units of gold.

And so the notion of a stable world currency requires a degree of flexibility in capital and labor flows, which we have not yet achieved.

RYAN (?): Mr. Chairman, the press has made a great deal out of your use of the word "deflation" the last time you appeared before the...

GREENSPAN: Did I use the word deflation? I thought I said...

RYAN (?): You, kind of, danced around it, but that's the way it came across.

GREENSPAN: That was my interpreter.

RYAN (?): It was your interpreter, all right.

I'd like to put the word right smack in the middle of the table and give you an opportunity to talk about it so that we can address the speculation, sometimes wild speculation, that has gone on in many of the columns that say, "We are on the verge of becoming Japan if we are not, in fact, Japan. Greenspan warns of deflation. And we're looking at 10 years of falling prices and sluggish economy," and all of the rest of that.

Can you just take that particular topic and deal with it in a way that we hope -- I hope will put some of these specters to rest?

GREENSPAN: It's a very serious issue and an issue which we at the Federal Reserve are paying

extensive attention to. And the reason basically -- and this indeed follows on naturally from my conversation with Congressman Paul -- with the elimination of the gold standard in the 1930s and the development essentially of worldwide fiat currencies, almost no economists believed that you could create deflation with fiat currencies because the ultimate supply of those currencies, by definition, comes from government fiat.

GREENSPAN: We went through most of the post-World War II period with the expectation that fiat currencies were essentially inflation- ridden and that the major focus of central banks was to suppress inflation. The notion that deflation would have emerged just never entered our minds until the Japanese demonstrated to us otherwise.

As a consequence of that, not having had any experience in the modern world with dealing with deflation and fiat currencies, our knowledge base was virtually non-existent, in the sense that we know how to deal with inflation. Inflation, obviously, is something that for a half century we've been struggling with. We know how to suppress it. We know the consequences of suppressing it. We know the impact of various monetary policy decisions on the levels of output growth and of unemployment. So we are familiar with the mechanism. It's not that we can very easily and automatically just suppress inflation; it has been a struggle of very great dimensions for most central banks in the world.

What's happened now is that since I guess the middle of the 1990s, we're beginning to see that it is possible for deflation to exist with a fiat currency, and in a way, it's, I suspect, credit to central banks, which essentially have restrained the expansion of credit enough that many aspects of the gold standard, which induced deflationary patterns in past periods, had been replicated in our monetary systems and that, frankly, is quite good.

We, at the Federal Reserve, recognize that deflation is a possibility. Indeed, we now have been putting very significant resources in trying to understand, without actually seeing it happen, what this phenomena is all about.

We cannot say that in the marketplace that there is a severe increasing concern of deflation. Indeed, the various expectations of price by both business and consumers has been relatively flat for recent years, and the so-called TIPS inflation premium -- that is the implicit forecast of the consumers price index, which is embodied in our TIPS treasury yields -- has not changed much over the last three or four years. So this is not something which the markets are beginning to sense is about to erupt and something which we must address.

Nonetheless, even though we perceive the risks as minor, the potential consequences are very substantial and could be quite negative. So we have created fairly significant resources to try to address this problem, increasing our knowledge of what actually happens, what's the process and what tools are necessary to fend it off. I think we've made very substantial progress in that intellectual endeavor.

We do, obviously, have the problem that we never dealt with this before. We know as a consequence that when we don't deal with something, we have a large element of uncertainty, which strangely we do not have with the implementation of policies against inflation because

we've dealt with it over so many decades.

We believe that because in the current environment the cost of taking out insurance against deflation is so low that we can aggressively attack some of the underlying forces, which are essential weak demand. And indeed, we've done that since we started a very aggressive easing in monetary policy in early 2001.

GREENSPAN: So long as the costs of engaging disinflation are so low, we have moved fairly considerably and in statements we have made, specifically, as you point out, the statement we made at our last FOMC meeting, to recognize this not as an imminent, dangerous threat to the United States, but a threat that, even though minor, is sufficiently large that it does require very close scrutiny and maybe, maybe, action on the part of the central bank.

BENNETT (?): Thank you very much.

I'm told there is another 10-minute vote that started at 10:32. So, Mr. Ryan, you're back in charge.

RYAN: Thank you, Mr. Chairman.

I believe Ms. Dunn is up.

DUNN: Thank you very much. Thank you, Mr. Ryan, my more senior member. It's delightful to meet you and to have you in charge of this panel.

It's nice to see you, Mr. Chairman.

I have a few questions I would like to submit to you in writing. They have to do with the WTO and how United States tax laws could potentially put our exports at a disadvantage. I would appreciate your comments as I submit those questions on how we can find an approach as we iron out the FSC-ETI WTO problem that will result in some compatibility with the obligations I certainly feel to some of my employers who are United States-based manufacturers. So, with your approval, I'll get those questions to you.

I do have a couple of questions, and, depending on time, on your testimony, a few others that have popped up as my colleagues have asked your questions.

You mention in your statement on page 4 that geopolitical uncertainties have been resolved. One question that I have, because of my involvement as the vice chairman of the Homeland Security Committee on the House side, is whether uncertainties here at home are having an effect on the economy.

Mr. Ridge, as you well know, has just raised the threat level to orange. Has the economy adjusted since 9/11 to the threat to homeland security or is there some underlying drag on business investment that's caused by security warnings that are issued by the government?

GREENSPAN: Congresswoman, this is a very difficult question to get a handle on, because we don't have enough history, we don't have any hard data.

As you're aware, the financial markets took a very severe shock as a result of September the 11th, and we were most concerned of the stability of the system and pumped in huge amounts of reserves and engaged in many different activities to make sure we could stabilize the system.

One concern that we had was that a follow-up of terrorism would occur two, three, four weeks after September the 11th, and we were worried about the fragility of the system at the time.

In retrospect, that did not happen, and indeed nothing has happened since in the United States. Nonetheless, there's got to be some residual overhang in longer-term expectations. But it is very difficult to ferret it out of the financial data.

So one can conclude that, yes, it seems most likely that there's got to be some residual concern, but it is not, at least as of the moment, of an order of magnitude which becomes a major factor in economic or in, for that matter, homeland security policy, so far as the economy is concerned.

DUNN: Thank you.

Do you think that the time is right for us to undertake fundamental tax reform?

I ask you that because the complexity in the code continues to be greater and greater. No matter which way we look, whether it's in our discussion of the decrease of taxes on dividends or the capital gains treatment of assets or the difficulties with our trading partners as to how we treat exports coming from our country or the treatment of certain assets that are based on the type of ownership of those assets, it is just simply a continuing problem that we run into with the complexity of the code.

DUNN: Is there a way to fix this code, do you think, without fundamental tax reform?

GREENSPAN: We did: 1986-1987.

The problem is not in fixing the code. We know how to do that. We probably could improve it immensely. The trouble is, what do you do after you fixed it? Because there seems to be a propensity in our process to reemploy all sorts of variations, changes in the tax code, to obtain one public policy purpose after another. And we end up with, apparently, where we started.

So if you ask me, would I like to see tax reform? Most certainly. There is no doubt that our tax system is rife with incentive-stifling regulation, taxation, burdens of all forms.

I thought we had made a major breakthrough in the -- what was it? -- 1987 act. And I'm discouraged, because if we find a way to create a major improvement in the tax structure, which undoubtedly is overburdened with unbelievable detail, do we have a mechanism, either politically or statutorily, which can freeze the structure, or at least in part?

DUNN: One more question?

RYAN: We're going to do a second round.

DUNN: Great.

Thank you, Mr. Chairman.

RYAN: Thank you, Mr. Chairman.

I would like to maybe pick up where Ms. Dunn left off, and that is, in '86 we did do fairly comprehensive tax reform, then the rest of the world followed suit with their own versions of tax reform, lowering their tax rates on capital.

Now, since 1986, we find that when we examine the U.S. tax code, that we actually tax capital on most instances, but especially in dividends, higher than any other industrialized country in the OECD. And so when we take a look at the fact that capital is being taxed higher than the other OECD nations, I would argue, and I would like to ask your opinion on this, that that is pushing capital overseas, away from the U.S., to lower tax jurisdictions.

So when we take a look at what we're about to do here in Congress on tax policy, as early as tomorrow the House will bring up a bill that has a tax cut, and this is a tax cut that we budget for in our budget resolution. It's not revenue neutral in the pristine sense that we raise taxes for every dollar we cut taxes, but we do have this included in our budget resolution, which does get us onto a glide path to balancing the budget within the next 10 years.

The key component of actually doing that, though, is that we grow our economy. And when we take a look at tax policy that actually reduces the tax rate on capital, that actually increases the after-tax rate of return on investments, the bill we're passing tomorrow I think does just that. It accelerates the marginal income tax rate cuts that were scheduled to take place in 2006 up to this year, retroactive to January 1st of this year, so all the rate cuts come in right now. That's the tax rate that small businesses pay.

Right now, a lot of people don't know this, but small businesses like Sub-S corporations, sole proprietorships, actually pay a higher tax rate than large corporations do. With this tax bill, that will be made lower to 35 percent.

The tax bill we're also passing, hopefully, tomorrow in the House, brings the capital gains tax rate down to 15 percent and the dividends tax rate down to 15 percent for the rest of the decade.

What I'd like to ask you, Mr. Chairman, is, number one, even Keynesians might argue in a deflationary environment that tax cuts are a good idea at this time. Do you believe that tax cuts that seek to lower the price of capital, that seek to encourage investment, are a good thing at this time? And number two, are these particular tax cuts, lowering the tax rates on dividends, capital gains, and marginal income tax rates across the board, good tax cuts that actually do encourage investment?

GREENSPAN: First, Congressman, let me just repeat a cliché which happens to be true, mainly that capital doesn't pay any taxes; only people pay taxes. What happens is, you impose taxes on organizations which then deflect them elsewhere. But at the end of the day, all taxes are paid by people.

I have always argued that this is a very inefficient way of organizing revenues within a government, and that we're far better to tax -- gain our taxes directly, rather than putting it on capital. Because all it does, it slows down the growth of economic activity and the revenue base from which the revenues actually occur.

GREENSPAN: And I've argued over the years for the elimination, where we possibly could, of taxes on capital. And I, as you probably are aware, have always argued for the elimination of the capital gains tax. And the reason is is that I think it's an extraordinarily inefficient tax -- inefficient means of raising revenue in the sense that by posing itself on capital reduces the growth rate in the economy.

Now, having said what I just said, I need not answer the rest of the questions that you raised.

RYAN: I think you did. Thank you, Mr. Chairman.

One last question: The crowding-out argument seems to take a lot of hold these days; which is, that deficits, as we have right now, are propping up interest rates. But if one looks at other data, say Japan, where their GDP and deficit ratios are far higher than ours, where their long-term interest rates are extremely low, current data, showing that the deficit exists is growing but our long-term rates are low, seem to suggest that this crowding-out, you know, argument doesn't really hold much water, given the data we have available here in the U.S. and across the world.

What are your thoughts on that?

GREENSPAN: I think the argument that it doesn't hold in Japan is accurate; but therefore it doesn't hold in the United States is false.

And the reason I say that is that the evidence that we have very clearly, and very robustly as economists like to say, indicate that interest rates are a function of the long-term expected deficit. We, indeed, have just published a study which is really quite difficult to get around if you're a statistician. The numbers are pretty robust.

The reason why it doesn't show up in Japan is cultural. There is an extraordinary propensity on the part of Japanese households and others to hold only yen-denominated assets. And very little of the huge debt of Japan is held outside of Japan. Indeed, the only areas that I'm aware of are in index bond loans, which are required effectively to essentially diversify their bond holdings.

But because of that what you get is a very low interest rate, because if you take the savings propensities of the Japanese people, which are commendable, especially compared to ours, they actually press interest rates down. In the United States that is not the case.

If there was a very significant part of Japanese yen-denominated government debt, JGD, so to speak, held by foreigners, you would find interest rates very much higher in Japan than they currently are.

RYAN: Your statement on the distinction between America and Japan, does that hinge based upon the size of the deficit relative to the size of the economy?

GREENSPAN: It's largely a reflection of very different cultures. We do not have a culture where people, as patriotic as they may be, will hold on to dollar-denominated assets if they can do better elsewhere.

RYAN: But the crowd-out effect on the U.S. is determined by not the nominal size of the debt or deficit, but the relative size of the debt or deficit relative to the size of the economy.

GREENSPAN: That is correct. It is related to the relative size of the deficit essentially to either the GDP or net aggregate flows.

RYAN: Thank you.

I yield back, Mr. Chairman.

BENNETT: Thank you very much.

Senator Alexander?

ALEXANDER: Thank you, Mr. Chairman.

Chairman Greenspan, excuse our going in and out.

I have two questions, and I would like to illustrate them by circumstances in Tennessee. The first has to do with natural gas.

If I were one of your interpreters and I were listening to your comments today, I'd say somewhat encouraging would be the news, except a big red flag that I noticed in your testimony had to do with natural gas.

You spent some time talking about it, even though you said on balance, energy prices are more favorable for the economy. I feel the same way. In my role as chairman of the Energy Subcommittee, I hear a lot about natural gas.

For example, Tennessee Eastman has 8,000-10,000 people in Tennessee. They're a chemical company. They came in the other day, when natural gas prices went way up, they took a 6 percent management pay cut and a 3 percent pay cut for the several thousand employees, just to keep from laying off people; so it affected jobs.

ALEXANDER: And as I look at the next winter, based upon the very factors you talked about, things don't look much better for natural gas prices. And that could have a profound impact on costs of many of our major manufacturers, and that could result either in layoffs or the movement of jobs overseas.

So I wondered if you wanted to say more about your thought about the long-term effect of natural gas prices on jobs and the economy, and if you had any suggestions for policy that we ought to consider as members of Congress.

GREENSPAN: Senator, I am quite surprised at how little attention the natural gas problem has been getting because it is a very serious problem.

It's partly the result of the new technologies that have been employed in the areas of drilling technologies and the whole exploratory procedures which have evolved over the last decade or so. Seismic surveillance has improved the rate of so-called wildcat successful wells by double. I should say it's more than seismic issues, it's basically the new technologies.

The end result is that we are so good that the new findings of natural gas reservoirs are drained by half in the first year. And as a consequence, even though we do a considerable amount of drilling -- and there's been a fairly substantial rise in natural gas drilling rigs -- just to keep up with the drain is a major problem in itself.

Unlike oil, which when we run into a problem we can import, we cannot -- we cannot -- do that in natural gas. And the major reason is that, not that there is not a huge amount of gas in the world -- is a fact I'd like to point out -- it's really quit abundant. The only way to get it to the United States, other than Canada and Mexico, is to bring it in with cryogenic liquefied natural gas carriers which have created a major environmental problem. We have very vehicles which enabled us to tap the world natural gas market. And the reason essentially is our capacity to bring in natural gas in cryogenic form is extremely limited.

And if, on the one hand, we have encouraged, as we have, very significant growth in domestic demand for natural gas, but very readily constrained by our ability to increase supply, then something has got to give. And what is giving, of course, is price. And price, now it's \$6 per million MCF is pressing down, as you well point out, on a number of industries which rely very heavily on natural gas. And I don't think we've yet seen the implications of this, but they are going to arise.

And if it's coming to your subcommittee, I suspect you're going to find a number of people are going to start to watch very closely, because this is an issue that we have not addressed. And we have, I'd say, contradictory federal policy.

ALEXANDER: Mr. Chairman, may I ask one more question?

BENNETT: Surely.

ALEXANDER: Chairman Greenspan, you've talked, here and earlier, about the strength of our

flexible economy and the importance of competitiveness.

We now have about 900 auto part suppliers in our state. Most of them buy steel. Most of them have a 25 to 30 percent increase in the price of the steel they buy since the steel tariffs came in. I wondered what comment you might have or what effects you might have seen of the Section 201 Safeguard Steel Tariffs on the economy as a result over the last several months, and whether you think those tariffs are a good idea.

GREENSPAN: Well, I testified at various different hearings not on that issue directly, but inevitably the question came up. And I expressed and continue to express considerable chagrin at endeavoring to create a severe limitation on imports of steel.

GREENSPAN: I think we'd be better off without them, and I hope that they will eventually be dispensed with.

I do not deny that apparently a number of structural advances have occurred in the old, traditional coke oven, blast furnace, steelworks, rolling mill integrated operations, and we've squeezed them down quite considerably and even addressed the legacy costs, which are so important with those types of institutions.

But I think over the long run we have to be very careful to recognize that artificially increasing the price of steel in the United States has and will continue to induce individual steel users to move abroad if they can, out from under the pressures -- the high tariffs that are involved here.

I think there have been job losses here on the part of steel users. There clearly have been job losses in steel. And I think it's a very tricky problem, which I don't deny is readably resolvable.

But I do think over the longer run we should, as quickly as we can, take those tariffs off and open up the market to competitive forces, which I think is what this country's all about.

ALEXANDER: We often hear about the job losses in the foundries. We don't as often hear about the job losses at 900 auto part suppliers employing 150,000 people just in one state who are looking to keep costs low, and if they're not low they move the jobs to Mexico.

Thank you, Mr. Chairman.

BENNETT: Thank you.

Chairman Greenspan, as I was coming back over from the last vote I was asked by a representative of the press what I thought about the current status of the jobs and growth package as it is emerging from the conference committee between the House and the Senate. And I was able to say with complete candor, "I don't have the slightest idea what the current shape is. Any information I have about the shape of it is 24 hours old, and in this atmosphere that might as well be last year."

So the press representative enlightened me and said, "It now looks as if the House is on top and

the House version will prevail, and how do you feel about that?" And this also was a very easy answer. I said, "I prefer the Senate version." Being a senator, that comes very normally.

But that stimulates me to take advantage of your being here to discuss the question of long-term tax structure. I accept wholeheartedly your comment about the time lag between actions on fiscal policy and the economy. I've supported the elimination of the taxation on dividends on the grounds that it is a long-term intelligent thing to do in order to make the economy more flexible and more responsive long term. And even if it doesn't have a short-term kick, it will help us over the long term.

Now, apparently the House has taken the position that dividends ought to be taxed as if they were capital gains, at a 15 percent level, and they're reducing the effective capital gains taxes to 15 percent. At least that's what I gather from my source in the Fourth Estate who shoved the microphone in my mouth as I got on the elevator.

Could you comment for us on the relative wisdom of these two approaches, the question of reducing taxation on dividends and the concept of tying dividend taxation to capital gains taxation and where should the appropriate rate be on capital gains and so on?

I've been given a quote here from Robert Lucas, who has a Nobel Prize, who says that eliminating capital income taxation would increase capital stock by about 35 percent, leading to his quote, "the largest genuinely free lunch that I have seen in 25 years in this business," unquote.

Do you agree with Mr. Lucas or do you defer on that? What's your comments about the whole question of how capital should be...

GREENSPAN: Well, I haven't...

(UNKNOWN): Mr. Chairman, I apologize for interrupting, but I have to leave, and Senator Kennedy has a written statement that he'd like to enter into the record, if that's OK.

BENNETT: Without objection, it shall be in the record.

GREENSPAN: I can't comment on the 30 percent, but I think the sign is right. I do believe, as I've indicated previously and repeated today, that taxation of capital per se is misguided, in the sense that it ultimately falls on individuals, and that we ought to direct the tax to people who pay it, rather than allow indirect incidence of taxation flow to many people -- inadvertently tax them without their being aware that they're being taxed.

As I said, I don't know whether the 30 percent number is correct, but I'm sure he's correct in the direction. And anything we can do to remove taxation on capital will enhance the revenue base and probably do more to incomes of lower- and middle-income Americans than any other tax-type vehicle we would impose.

The major problem, as I mentioned to Congresswoman Dunn, is we could get a...

BENNETT: I apologize for not having been here to here to hear...

GREENSPAN: No, but it was an interesting conversation, because she's raising much the same issues that you are.

And I said we did that in 1987 to a greater or lesser extent. The problem is, we always creep back. And I was wondering that it's fine to get a tax reform bill, but is there any way in which we can guarantee that it doesn't get revised, because we seem to revise them very rapidly, going back?

I would just assume not get involved in individual discussions on particular things, because I'm 48 hours behind schedule.

BENNETT: I thought I could drag you into that, but very appropriately, you refused to enter the thicket, so I congratulate you on that.

Do any of the members of the committee have a second round -- want to participate in a second round? All right, let's see.

Oh, Senator Sununu, we welcome you and it's now your turn.

SUNUNU: Thank you, Mr. Chairman. And I do apologize to both chairmen. We have a Foreign Relations markup that proceeds apace.

Mr. Chairman, you talked about the experience in Japan. You also talked about cultural differences and investment practices. Two questions about Japan.

First, to what extent do you think those cultural differences, differences in investment practices, contributed to or lessened the severity of Japan's problem with deflation?

And second, what did you learn from the experience of Japan?

GREENSPAN: Well, it's hard to know about the deflation issue, but I will just tell you what I've been telling my Japanese colleagues both privately and publicly, and they agree. And the issue is the following: that in order for economies to grow, you need to have obsolescent capital move out, usually through depreciation charges or into cutting-edge technologies. That's the way productivity grows, that's the way economies grow.

Japan did exceptionally well for 40 years, because they never had to confront the problem, which is a serious problem today, namely discharging people and causing companies to go bankrupt, both of which very significantly induce a loss of face, which is culturally unacceptable in Japan. For 40 years, their number of bankruptcies were negligible, and they had lifetime employment, because their growth rate was so spectacular, and their ability to recover from the ashes of World War II was quite remarkable. They now are the second- largest economy in the world.

As soon as they slowed down, as they inevitably had to slow down, having become as large as they were, they ran into the problems of creative destruction, and they are culturally having difficulties addressing those issues. And the result is that banks are very reluctant to take collateral and sell it, because that would bankrupt the borrower, or to discharge people. And unless and until they address this issue, in my judgment, they're going to have serious difficulties.

I raised this with many senior people in Japanese government. One of them said to me, very succinctly, said, "You have it exactly right, but you don't understand. Your solution is not the Japanese way," and it is not. And I think there has to be some mechanism which they find to resolve these issues.

They understand them. It is not a great mystery to anybody what it is the problem they have, and they're working very diligently, as best I can justify (ph), to find ways in their culture to solve the problems that confront them.

SUNUNU: And those obstacles to moving obsolete capital, they're specifically the reluctance to discharge or to deal with the large amount of debt that sits on the books of some banks, as well as, sort of, a cultural dislike for the bankruptcy process.

SUNUNU: Do both of those fit into that category?

GREENSPAN: Remember that a very significant amount is -- a very significant part of the loans that are made by Japanese banks are collateralized by real estate or by other types of business assets. So long as the collateral is held in the bank, the individual borrower can function as though it had full control of the collateral. If, however, the loan is to be written off, the collateral has to be sold, which means that you take the building away from a company or you do other things with respect to their assets, which effectively throws them into bankruptcy, and that's been a very reluctant activity on the part of Japanese banking.

SUNUNU: I apologize if you've already addressed this issue specifically, but could you comment on the current strength of the dollar, and whether or not it's appropriately valued?

GREENSPAN: No, Senator, I cannot. And the reason I cannot, as I indicated to your colleagues, we in the United States government have a pact in which all conversations with respect to the value of the dollar are in the bailiwick of our chief financial officer, chief economic spokesman, the secretary of the Treasury.

SUNUNU: Do you think the secretary's doing a good job?

(LAUGHTER)

GREENSPAN: I do. I do. I mean, he's a very capable individual.

SUNUNU: Thank you.

On the European Central Bank, could you comment about their current policies and the degree to which their current monetary supply -- do you feel that it's appropriately loose or tight?

GREENSPAN: Here again you raise issues which...

SUNUNU: But there's a pact between central bankers as well. I'm sorry.

(LAUGHTER)

I apologize for not having the list of pacts in front of me. I understand.

GREENSPAN: Let's put it this way. We central bankers talk to each other a great deal and give each other advice, and we work very well together and I think very effectively as a, sort of, G-10 governors in Basel.

I have been very reluctant, and I think very appropriately, that it is just not appropriate for individual central banks to comment on the policies of others when we know how hard it is basically to do our jobs. And I don't know as much about Europe and the European financial system by a very significant order of magnitude that my colleagues at the ECB have.

SUNUNU: In your testimony, you discussed the current earnings reporting cycle and indicated that there's been some good news there. Has there been any news, positive or negative, that has surprised you in the current cycle of earnings reports?

GREENSPAN: The earnings are doing better than I would have anticipated.

The second quarter is still, of course, open, but the current estimates are, even though the GDP in the second quarter is going to be quite soft, earnings are pretty flat. They're not going down. In other words, the productivity is essentially showing through into significant improvements in profit margins and in earnings.

SUNUNU: What do you think the specific factors are that are driving those productivity gains?

Again, you mentioned in your testimony the surprising continued strength of productivity growth. Are there any specific factors that you feel have been driving productivity over the last six to 12 months?

GREENSPAN: Well, as I point out in my prepared remarks, I think the best explanation of where that is coming from is the result of a very significant amount of accumulated inefficiencies that developed from 1995 to 2000, as a consequence of capital investments being very largely focused on market-expanding activities. And those are the types of capital investments which offer very large potential rates of returns, if they work.

Very little was done, as best I can judge, in endeavoring to approach cost-cutting, which is usually very effective, but it's not a huge rate of return. And I think that over the latter part of the 1990s, a lot of inefficiencies through inadvertence built up, and now managements are going

back and exploiting those backlogs of inefficiencies, and they show up as significant improvements in productivity.

SUNUNU: When you talk about...

BENNETT: We're going to have a second round, Senator.

Senator Sessions?

SESSIONS: Thank you very much, Mr. Chairman.

Mr. Greenspan, just to follow up on that productivity thing, some commentators I note in the papers indicate that it does cause, at times, layoff of employees. But would you share with us your thoughts as to why it's good in the long run?

GREENSPAN: Well, it is certainly the case, Senator, that when underlying productivity growth is at a higher rate than it had been, that you need a higher rate of growth of general GDP in order to create jobs. But because productivity per se is the base by which we measure the growth in standards of living and the effectiveness of an economy, clearly the greater the degree of productivity growth the better.

That does mean that it does raise the barrier of what we are required to create with respect to GDP growth if we're going to employ our labor force appropriately.

SESSIONS: I know you mentioned in your written remarks the oil prices and the relatively prompt conclusion on the war in Iraq and the prices have fallen. The conventional wisdom is that falling energy prices are a positive indicator for the economy. Would you share your thoughts on that, if you haven't already?

GREENSPAN: No, in fact, it's an issue which you're raising which I think is probably worthwhile reemphasizing.

We import a considerable amount of our oil. And as a consequence, when the price falls we, in fact, for that imported amount of oil, both crude and products, we get a net benefit -- that is, the American people get a net benefit.

For energy which is produced solely domestically, it's merely a transfer of incomes from producers to consumers and back and forth. But the one thing that is distinct about oil is that it's one of our major sources of energy for which imports are a very big issue.

SESSIONS: I've felt that pretty strongly that when the amount of wealth spent to import oil and energy is a big deal for the American economy. So that argues, I guess, pretty clearly that conservation, domestic production and efforts to contain the world price are the kind of policies that could have a significant impact on the economy. And the fact that you're paying greater amount for fuel as a result of a world price, it's like a tax on the American people for which they get no benefit. Would that be fair to say?

GREENSPAN: I think it's perfectly accurate to put it the way you just did, Senator.

SESSIONS: I'm concerned that we're not going to meet our power generation plans and goals without a reactivation of nuclear energy in this country. France is now 80 percent of their power. And we have -- the plants that are operating in the United States are setting records for safety and efficiency.

Do you have any thoughts about the role of nuclear power, both for the environmental benefits of clean air and containing the demand on natural gas?

GREENSPAN: Well, obviously, the big problem with nuclear power disposal of wastes, but if we can resolve that issue, the advantages of nuclear power are very considerable.

And indeed, as you point out, Senator, the technology has improved very measurably over the post-World War II period. And safety, as you pointed out as well, is clearly very formidable issue.

There is no energy production which is risk-free no matter what we do. The point at issue is to remove the level of risk to the lowest levels that we can. And I do think that we ought to be spending more time at least looking and contemplating the issue of nuclear power, especially since, as I mentioned in a discussion with Senator Alexander, that natural gas is a real serious problem.

GREENSPAN: And the reason basically is that we don't have a capability of importing very substantial amounts of it from other than Canada or Mexico, and we don't do much with Mexico. In fact, it's basically the other way around.

So I think that, if we're going to continue to expand our energy base, we're going to have to be starting to look at nuclear power as a potential reservoir of new sources of energy which are not available by other means.

BENNETT: Thank you.

Well, we will have a second round. And according to my list, Congressman Paul, do you...

PAUL: Thank you, Mr. Chairman.

I wanted to follow up on your comments about not being able to...

BENNETT: I'll monitor the time a little more emphatically in the second round than I did the first.

PAUL: Earlier we were talking about your ability to talk about the value of the dollar and what it should be. I find that rather ironic. I mean, the Federal Reserve is in charge of the monetary system, and you, as chairman, have a lot to say about what monetary policy is and how much

money will be printed and created and what interest rates would be. So we find it a bit ironic that you can't comment on the value of the dollar, and we defer to Treasury.

Now, Treasury can play a role, of course, by intervening in the exchange markets, but that's very temporary. But I understand the policy and we don't expect you to change that, but in a way you're really in charge, and it's too bad that we can't get comments about the dollar.

I did want to remind you about following up on the question about foreign policy -- how foreign policy anticipation of what we might be doing around the world might affect fiscal and monetary policy and trade policy, how that might affect perceptions of the dollar and whether or not that's important.

But on the currency issue, I'm still not interested in going back to fixed currency rates, such as the Bretton Woods Agreement. That's not my interest. Because even then Henry Haslet (ph), I remember, wrote very correctly back then that Bretton Woods would break down, and it certainly did break down, it didn't work with that so-called gold exchange standard.

But if you have achieved what you hope you have achieved, and that is that central banks now have done such a good job in managing paper money that it's starting to act like a gold standard - now, that would be an historic achievement, you realize that, because it has not been done in 6,000 years of recorded history. And history's on my side of this argument, in that paper money doesn't work very well. Paper money ends badly. And we may be seeing some signs today around the world that paper money is a very shaky system.

But a more specific question dealing with that in a return to commodity money, at least on a voluntary basis, if we have a Third World nation that destroys its currency and they don't have the advantages that we have politically, if they destroy their currency and they want to link their currency to gold because they know history, they're not allowed to do it. The IMF prevents them from doing it. There's an IMF rule that says you can't do it.

So wouldn't this be a good time for us to become more neutral and not antagonistic toward gold and say to the IMF and to our position that, "If you choose to go back and get stability and soundness to your currency with a linkage to gold, we ought to permit that?"

GREENSPAN: Well, I believe a country has the capability of doing that. I'm not sure what the rule is in the IMF, but if they were going to link their currency to gold and they believe that was going to stabilize their system, they wouldn't need the IMF.

PAUL: But there's a prohibition if they want to stay in the IMF with that.

What about the foreign policy question?

GREENSPAN: I don't see how I can answer that without breaching the agreement about not talking about the currency. I mean, I don't know how to phrase an answer to your question...

PAUL: OK.

GREENSPAN: ... without implicitly doing that.

PAUL: I yield back.

BENNETT: Ms. Dunn?

DUNN: Thank you very much, Mr. Chairman.

Mr. Greenspan, I was intrigued by a report in the newspaper a few days ago that had to do with Iraq's being encouraged by the United States to leave the oil cartel and in effect flood the market with oil.

DUNN: I don't know if you read that. But if you did, do you have any comment on the effect of that, and whether that's a possibility if it could be worked out? And what its positive aspects or any aspects would be on the United States?

GREENSPAN: I didn't read the articles closely, but I glanced at them. I wasn't aware that that's official policy, as far as I know.

DUNN: I don't think it's official policy, but there was some -- I don't know if it was leakage or not, but that was...

GREENSPAN: There are lots of people who hold that view, but lots of people hold lots of views, and I'm not sure...

DUNN: Whether it's official policy or not, could you speak briefly to the effects that it would have on the United States?

GREENSPAN: Remember, the president has said that the oil belongs to the Iraqi people. Their judgment as to whether or not they wish to remain in OPEC or not remain in OPEC or deal with them one way or another I think is an issue which they eventually -- meaning those who are in control of the oil -- are going to have to make.

DUNN: Let me ask you about a comment that you made on page 5 of your testimony: "Airlines have, obviously, suffered another blow due to the SARS outbreak, in effect." What do you think is the future of the airline industry?

GREENSPAN: I'm statutory chairman of the Loan Board and have been successful in delegating all my authorities to Governor Gramlich, who has done a far better job than I could have done on this issue. As a consequence, I've not looked at the airline industry in great detail. I have economists' views about what should happen, but that really gets to the issue of the degrees of deregulation.

In other words, remember that we significantly deregulated essentially the revenue side of the airline industry following the mid-'70s to very great effect. We augmented airline travel by a

huge amount. I think, however, we're still involved with many of the regulatory structures that existed prior to deregulation on all other aspects of airlines, and I think they're running into troubles where, as somebody said, the net earnings of the airline industry since the turn of the last century is zero. And that tells you that structurally something is askew here, and we need to address this in a manner which makes them far more valuable.

I mean, the technologies are just remarkable. I mean, it's hard to believe that an industry that sophisticated is unable to make an adequate rate of return, but they're not able under existing sets of regulations.

DUNN: A few months ago some of the members of the airline industry were making comments that nationalization of the airline industry was a possibility. Do you think that's a possibility?

GREENSPAN: I certainly hope not.

DUNN: Thank you.

BENNETT: Senator Alexander?

ALEXANDER: Mr. Greenspan, I want to suggest a concept here and see whether it makes any sense as you look at the economy and try to make judgments.

I've been thinking that since September 11 that we've had imposed upon us in our country a, sort of, terrorism tax that would be composed of a variety of different costs: the actual costs of security, for example; the costs that come from the loss of productivity as people watch television or do other things worrying about terrorism; the costs that come from a lack of consumer confidence as people become nervous and postpone decisions. You mentioned a little earlier the lack of business confidence as some business people are nervously postponing decisions.

I wonder if you've tried to put in one bucket all of these costs that have come as a result of the terrorism attack on 9/11 and since then and apply that to the economy we have today.

ALEXANDER: And I wonder what the economy would be like if we took the cost of the terrorism tax out of the picture. Seem to me it would be a booming economy.

GREENSPAN: It's very difficult to judge, Senator. What we do know is in the period immediately subsequent to September the 11th, a number of us endeavored to try to add up numbers of the type that you're talking about, both qualitatively and quantitatively, and concluded that it's a rather large burden.

The problem, however, is looking from here in retrospect it's difficult to find it, the aggregate figures. In other words, productivity is better than we expected. The degree of flexibility of our economy and resilience is better than we would have expected.

In short, while one would certainly have to argue, because there's no way avoid it, that there's got

to be some cost in -- dead weight cost on business and on households from this, it is not easy for an economist to extract it from the macro data. In other words, the economy is not behaving in a manner which suggests that these costs are overwhelmingly depressing.

It could be. I can certainly conceive of a situation which we'd find that. It's just not evident in the database.

ALEXANDER: So instead of jumping to a conclusion -- well, common sense tell us, as you just indicated, that there are bound to be some significant costs, I mean whether you walk into an airport or whatever. But rather than jump to the conclusion that had it not been for 9/11 the economy would be booming. I guess another possibility would be that the strength of the country has found ways to compensate for that and in other ways and adjusted and maintained the strength that otherwise we wouldn't have been challenged to maintain.

GREENSPAN: Senator, I think that this raises a much broader question about governmental policy, which goes through fiscal policy to homeland security and the like. And it's to recognize, as we've discussed this morning, how important the issue of improved resilience and flexibility the American economy has been to our society.

We've had huge deregulation in the last 25 years. We have major globalization, which improved competition. Technology very markedly improved real-time auditing of business imbalances and prevented them from festering and creating serious difficulties.

And it strikes me that one lesson we should be learning from all of this is that if we're trying to improve the economy one of the best ways we can do so is to improve the flexibility, and hence the resilience, of the economy, so that irrespective of the types of shocks, which are evident in the last several years, there's a base there which can fend them off. It's better not to catch a cold than have to fight it off after you've got it.

And I haven't tried to do the arithmetical exercise, but I would suspect that the returns that we would get if we try to estimate, for example, what the American economy would look like today if it did not have all the improvements that I just mentioned, we would find the GDP, in my judgment, down very significantly and the macroeconomic impact of flexibility -- in other words, what is the consequence of flexibility on GDP growth? -- I think we would find the numbers to be exceptional large and, indeed, probably dwarfing many of the expected outputs from some of the initiatives we've been talking about today.

ALEXANDER: Thank you.

BENNETT: Senator Sarbanes?

SARBANES: Well, thank you very much, Mr. Chairman.

And I apologize that I wasn't able to be here earlier. And I apologize to Chairman Greenspan. I started out this morning, I had three committees meeting at the same time. My initial reaction to that was not to go to any of them.

(LAUGHTER)

But I then concluded that that would be a dereliction of duty, so I'm trying to work through the list as best I can.

BENNETT: The senator just confessed something to which all senators are guilty at one point.

SARBANES: Chairman Greenspan, we're obviously pleased to have you back before us.

SARBANES: And I'm going to put two or three quick questions.

First of all, I know you've already addressed the unemployment insurance issue earlier, but you previously indicated that there are periods when the context is such that the restraints on the unemployment insurance system ought to be eased, and I guess I have a very simple question to put to you.

In a period in which the unemployment rate continues to go up, the long-term unemployed now are at the highest level they've been in almost 20 years, we're now facing the issue here of extending unemployment benefits. The average duration of unemployment has now gone to 19.6 weeks, which is the highest since January of 1984. Would you regard this as a situation in which the economic context is such that we would to consider extending these unemployment insurance benefits?

GREENSPAN: Senator, in answer to that question earlier what I did say, after repeating what you've heard me say in the past about the unemployment insurance system which we have is one far superior than any other that I've seen around the world in the sense that it does not encourage people not to take jobs...

SARBANES: It's pretty stringent in some respects in that regard.

GREENSPAN: Exactly. And I think that because it is stringent in normal periods, that one should recognize that people who lose jobs not because they did anything and can't find new ones, you have a different form of problem, which means that you have to allow the unemployment system to be much broader and, indeed, that's what we tend to do.

I do, however, argue that we have to be careful about creating permanent, temporary extensions, if I may put it that way. And I was suggesting to your colleagues that should you be going forward in an extension that it's far more important to have a short extension and if necessary just repeat it at a later time, because it is at this stage unclear as to whether we're at a fulcrum of a fairly significant economic recovery, which would make the necessity of a long-term adjustment in the unemployment insurance system moot.

SARBANES: On the trade deficit question -- of course, we now have this fall in the value of the dollar. How long can we go on running these large trade deficits and building up these very significant claims abroad on our productive capacity?

GREENSPAN: Senator, as you well know, the issue of how much you can build up net claims against American residents is a function of not only -- and this looks at a large function -- of the willingness of foreigners to hold and seek those claims. And indeed, what we have found over the years is that when the exchange rate for the dollar is rising, it, of necessity, means that there is a greater demand for dollars, and that's what occurred during a significant part of the 1990s.

But the obvious problem that you raise is, over the very long run, the ratio of cumulated claims against the United States, more specifically those which relate to debt, create interest charges which, in turn, are part of the current account deficit, which means that it is quite possible to get into an unstable equilibrium.

And that's an issue which economists have discussed quite significantly with respect to the United States. And as I think I've mentioned to you, Senator, I've been raising this issue for years and forecasting a major contraction eventually of the current account deficit, and I raise it every five years. I've been wrong every five years.

SARBANES: I know, but if we ever hit it, it almost would be like falling off the cliff, would it not?

GREENSPAN: No. I would think not, largely because the stock of dollar assets is so huge and the ability to move them around is fairly limited, that I think adjustments don't occur off the cliff for -- the question is, what do the holders do with those assets? They're so heavily involved in dollar-denominated claims that while obviously they can move out of them, and would, there are limits to how fast these things tend to move.

SARBANES: Can I ask one more question?

BENNETT: Yes, one more.

SARBANES: Kevin Hassett, an economist at the American Enterprise Institute, whom The Post reports has close administration ties, wrote the following analysis of the dividend tax cut the Senate adopted last week, and I quote him.

"Think for a moment of the likely wacky effects of such a plan. With dividend tax rates dancing like fairies for the next few years, firms will have difficulty setting dividends and shareholders will have even more difficulties figuring out what current dividends signal about future prospects.

"Since the elimination of dividend taxes is only temporary, investors must evaluate the risk that dividend taxes will come back. If they do, then the cash flows to investors from owning stock will plummet, as will the value of shares.

"Under such circumstances, it is undeniable that government policy significantly increases the fundamental risk of stocks. It would be hard to imagine that this would be good for the stock market or the economy.

"Clearly, this is one of the most patently absurd tax policies ever proposed," end of quote.

Now, I was going to ask you your opinion of this comment, but we've run out of time and I really, having had a chance to introduce the quote in the course of my question, I'll yield back now to the chairman so that the committee can proceed.

(LAUGHTER)

BENNETT: Thank you very much.

Mr. Ryan?

RYAN: Thank you.

I have a question regarding Iraq, but I'll just pause for a second to continue the Kevin Hassett quote, which is that he spoke very glowingly of the House version of the tax bill, which is what the House will be voting on probably tomorrow. And it's my understanding that the Senate may be voting on it as early as Friday.

So if you look at Hassett's analysis, he thought that the reduction of the dividend tax rate down to 15 percent for the rest of the decade was right on the money.

So, with that, Mr. Chairman, I wanted to ask you about post-war Iraq. And if you take a look at the Iraqi economy, which is, you know, hopefully coming together, one of the chief problems and big challenges facing Iraq is to have a currency that is a reliable store of value on which they can build back their economy. And if you look at the currency circulating in Iraq you would almost argue that it is effectively a dollarized economy already. And given that we are now talking about investing billions of taxpayer dollars into the reconstruction of post-war Iraq, one way that we could actually save money for American taxpayers, but also invest in Iraq, is to effectively dollarize -- help Iraqis dollarize and share a fraction of our seigniorage with the Iraqi government.

I'd like to get your reaction on a proposal to dollarize the Iraqi economy -- allow them to dollarize their economy, get a fraction of our seigniorage, and with that proposal would be a very, very explicit statement that any actions of the Federal Reserve or the U.S. government policy will not take into account or any considerations conditions in Iraq. So make sure we delink our monetary policy making with any other country that chooses to dollarize, but in the case of Iraq, who essentially is using dollars right now, give them some of our seigniorage, the money we make on printing more dollars, that they would be then using.

What is your reaction to that proposal?

GREENSPAN: Well, Congressman, actually the so-called Swiss dinars, as well as the Sudan dinars are circulating, and indeed are critical to the total currency system.

But very clearly it's important that a sound currency be instituted, and there are innumerable financial analysts from our government and elsewhere working with the Iraqi people and the Iraqi central bank to move in a direction of a sound currency, because you cannot have an economy grow without a means by which the division of labor can function.

GREENSPAN: And unless you have a sound currency, people won't trade with one another because they don't know what they're getting with respect to paper.

That's not yet a problem. But I do think that -- remember, the Iraqi economy was essentially a planned economy -- I mean under Saddam, not earlier. And the capitalist institutions, which are so crucial to development, are still moribund there, so that it's going to require a considerable amount of effort. But there are a lot of people giving a lot of thought, constructive thought, to how to handle this issue. And I think whether or not the issue of dollarization comes up, will ultimately be determined by the judgment of those Iraqis who ultimately will be part of the government which will make those decisions.

RYAN: Obviously laying a strong foundation is critical for their economy to grow. And taking out the uncertainty that accompanies new currencies or new currency regimes is clearly a goal worth achieving. Do you believe that we should consider, if they ask us, to share a small fraction of our seigniorage with Iraqis?

GREENSPAN: We always consider such issues. And indeed, that, of course, as you well know, has occurred in numerable other occasions.

And the question of sharing seigniorage is easily said, but very difficult to calculate. It's a lot more difficult. The question is -- I don't want to get into the details of, but in principle it's really obviously a viable operation; making it work is something else again.

RYAN: Thank you.

BENNETT: Thank you very much.

All members of the committee are encouraged to submit written questions. Many have indicated that they have those. And we appreciate your response to those, Mr. Chairman.

If I could ask just one last question, some people are concerned that lower interest rates could interfere with the functioning of money markets. Money market funds, for example, might have a negative net return if interest rates fall to 75 or 50 basis points. In other words, can you really go to zero? Do you have a comment on this?

GREENSPAN: Well, as you can imagine, Federal Reserve staff is focused on this issue in some considerable detail. And we have pretty much concluded where the key points of difficulties are and in what types of funds and what type of instruments held by money market mutual funds, which is where the critical problems arise.

We haven't completed our studies yet fully. And I don't want to prejudge where we go, but there

is obviously a question that you have significant impacts as you move short-term rates down through where the margins of money market mutual funds are. And then the question essentially arrests as to what happens when you do that, and we're spending some considerable time examining that issue.

BENNETT: Thank you. You'll be making a publication or do we ask you that question again?

GREENSPAN: That question has not been addressed at this particular stage. But obviously, when we come to conclusions, I would presume we would share them with you.

BENNETT: Very good.

SARBANES: Mr. Chairman?

BENNETT: Yes?

SARBANES: Could I just comment? I see there's an article in the New York Times a couple of days ago, headlined: "Surprise: The Fed Isn't Greenspan." And I just want to say I think Chairman Greenspan has consistently been aware of that fact -- and I think the extended efforts he's devoted to trying to develop a consensus on issues -- and we certainly have also been aware of it here. It was an interesting story and certainly an interesting headline.

Thank you.

BENNETT: Mr. Chairman, as usual, you have enlightened us and handled the various questions deftly and appropriately. We appreciate your willingness to appear before the committee and for your service.

The hearing is adjourned.

END

NOTES:

[????] - Indicates Speaker Unknown

[--] - Indicates could not make out what was being said.[off mike] - Indicates could not make out what was being said.